

**REPORT TO THE SECRETARY OF THE TREASURY  
FROM THE  
TREASURY BORROWING ADVISORY COMMITTEE  
OF THE  
BOND MARKET ASSOCIATION**

May 4, 2004

Dear Mr. Secretary:

Since the Committee's last meeting in February, the economy has continued to grow at a robust pace. GDP expanded at a 4.2% pace in Q1. Moreover, the latest economic readings point to a continuation of strong growth going forward. The ISM manufacturing report has continued to run at levels near the 20-year high reached in January. The latest data indicate robust home sales in March. Consumer spending grew almost 4% in Q1 despite higher energy prices and lower-than-expected tax refunds. The trend in payroll employment has strengthened, with job gains averaging 171,000 per month in Q1. The stronger trend in payrolls is consistent with the message from other employment indicators such as jobless claims.

Core inflation moved up in Q1. The core CPI rose an annualized 1.8% and the core PCE deflator was up 2.0%, bringing the year-over-year changes in March to 1.6% and 1.4%, respectively.

After maintaining its range even as most economic data pointed to a robust recovery, the Treasury market reacted sharply to news that payrolls are starting to pick up. Over the quarter, 10-year yields have risen by almost 40bp and 2s/30s curve has flattened about 15bp. Yields are currently 80bp higher than the lows observed in mid-March and the yield curve is 30bp flatter than its steepest levels of the quarter. The market is currently pricing in approximately 45% probability that the Fed will raise rates by 25bp at the June FOMC meeting and is pricing in almost 90bp of tightening by year end.

First quarter reported earnings have been strong: with 82% of the S&P 500 reporting, approximately 76% have beaten expectations while only 13% have failed to meet expectations. Despite strong corporate earnings, however, equity markets have declined over the past three months: the S&P 500 Index has fallen approximately 1% and the NASDAQ composite has fallen approximately 6%.

Driven by continued strong economic news and increased expectations of Fed tightening, the dollar has reversed its downward course over the quarter and strengthened almost 5% versus the Euro and approximately 4.5% versus the Yen.

Budget performance has been stronger than expected, with tax refunds only 8.6% higher than last year compared to Treasury's prior expectations of close to a 20% increase. At this point in the filing season, approximately 95% of non-withheld tax payments have usually been received, and they are running about 5% lower than last year.

Against this economic and financial backdrop, the members of the Committee began consideration of debt management questions included in the Quarterly Charge. Following their standard format, Treasury presented a chart package that will be released as part of the Treasury refunding announcement.

In its Charge to the Committee, Treasury stated that it will introduce 5-year and 20-year TIPS and that it will continue to increase TIPS issuance nominally and as a percentage of total debt outstanding. Treasury asked the Committee's advice as to where investor demand for TIPS would be greatest and in which sectors it would recommend reducing issuance. Members of the Committee were uniform in their support for a new 20-year TIP. Most members felt strong investor demand would be manifest in this sector. Members had differing opinions as to investor preference for 5-year TIPS with most expressing reservations about large-scale issuance. As to the question of which nominal issues to reduce in order to facilitate increased TIPS issuance, most members expressed reservations about canceling the reopening of 10-year note auctions. In fact, many members were reluctant to reduce nominal 10-year note issuance too dramatically. Members favored larger reductions in 5-year nominal issuance as well as reducing 10-year nominal issuance and bills. Because TIPS cash flows differ from those of nominals, replacement of like maturity nominals with TIPS was not favored by most members. In particular, the variable nature of the inflation component of TIPS' cash flows was a factor in most members' recommendations to reduce issuance of nominals along the yield curve. Other members voiced concerns that eliminating 10-year auctions may impede the risk transference utility that Treasury securities provide to the market by substituting less liquid securities for those that are more liquid.

The Committee then responded to Treasury's second question in the Charge by considering a number of slides that demonstrated forecast volatility in the Federal budget over prior cycles. Specifically, Treasury showed a slide depicting current and future budget projections in comparison with the January 2001 CBO baseline forecast. Treasury highlighted a number of contributors to the large forecasting error namely revenues, debt service changes due to legislation, spending, technical errors and economic factors. Treasury responded to past Committee guidance to show measures of forecast confidence around the Federal budget in out years. Treasury highlighted the fact that the changes in interest expense are largely due to factors outside of the control of debt managers. Treasury then presented a slide showing three financing strategies and expressed a preference for balanced issuance along the yield curve and asked the Committee to opine as to Treasury's tolerance for interest rate volatility given the difficulty inherent in forecasting required debt issuance. Committee members expressed support for Treasury furthering its ongoing efforts to implement analytical tools that illustrate borrowing needs and expenses under a wide array of scenarios. Members felt that risk analysis which illustrates interest rate expense and nominal borrowing requirements during

periods of fiscal deficit and high nominal interest rates, as well as fiscal surplus and low nominal interest rates, would be a welcome addition to Treasury's debt management process. Members also discussed adoption of a mean variance framework to debt management and concluded further study was required before a concise recommendation could be made to Treasury.

Treasury then asked the Committee to offer advice as to the scheduling of the November 2004 refunding. Three potential options were offered to the group for consideration. The consensus view was that it was necessary to be sensitive to the employment release and the FOMC meeting, while scheduling around the Veteran's Day holiday. Additionally, preserving the identity of the three-day auction schedule that draws focus and liquidity to the underwriting process would be favorable for the Treasury. The Committee recommended November 8<sup>th</sup>, 9<sup>th</sup> and 10<sup>th</sup> as the days following the November 3<sup>rd</sup> announcement to underwrite 3-year notes, 5-year notes and 10-year notes.

The Committee then addressed the question of the composition of Treasury notes to refund approximately \$32.03 billion of privately held notes and bonds maturing on May 17<sup>th</sup> as well as the composition of Treasury marketable financing for the remainder of the April-June quarter, including cash management bills for the July-September quarter. To refund \$32.03 billion of privately held notes and bonds maturing May 17<sup>th</sup>, 2004, the Committee recommended a \$24 billion 3-year note due 5/15/07, a \$14 billion 5-year note due 5/15/09, and a \$15 billion 10-year note due 5/15/14. For the remainder of the quarter, the Committee recommended a \$26 billion 2-year note issued in May and a \$26 billion 2-year note issued in June, a \$14 billion 5-year note issued in June and \$11 billion reopening of the 10-year note in June. The Committee also recommended a \$20 billion 11-day cash management bill issued 6/4/04 and maturing 6/15/04. For the July-September quarter, the Committee recommended financing as contained in the attached table. Relevant features include three \$26 billion monthly 2-year notes, a \$24 billion 3-year note, three \$14 billion monthly 5-year notes, a \$15 billion 10-year note issued in August followed by a \$10 billion reopening of that 10-year note in September. The Committee further recommended a \$10 billion 10-year TIPS for issuance in July as well as a \$10 billion 20-year TIPS for issuance in July.

Respectfully submitted,

Mark B. Werner  
Chairman

Ian Banwell  
Vice Chairman

Attachments (2)